INCLUSIVE ENTREPRENEURSHIP: APPROPRIATE BUSINESS FINANCE

1. SUPPORTING VERY SMALL BUSINESS

EQUAL supports micro-finance.

There is a recognised shortage in the *supply* of finance from banks to support small and micro-businesses[2].

The most important reasons are:

- The relatively high transaction costs of managing small loans. The EU defines micro lending as loans of less than €25,000 but in reality many businesses need even smaller amounts of capital;
- The second problem is *risk.* Banks use elaborate scoring methods based on credit histories to assess personal lending. But disadvantaged people often lack both collaterals and experience (or a business track record).

Studies also show that ethnic minorities refer to difficulties in accessing finance as the most important barrier to setting up a business, women as the second and young people as the third Regulatory reform[3] and the gradual withdrawal of traditional banks from the local and mutual economy, partially due to the pressure from the banking regulations (including Basel II), are predicted to make things worse[4].

However, there is also evidence[5] that there are problems related to the *demand* for micro-credit. Not all business proposals and people are "investment ready". The take-up of micro-credit is heavily affected by the competing availability of grants and the tax and social security implications of setting up a business.

In this highly complex scenario, it has become clear that it is not enough simply to increase investment in funds, which offer smaller loans. On the one hand, the take-up of such funds has been slower and less than expected in some countries and regions. On the other, some people warn that an indiscriminate increase in small loans could simply increase problems of over- indebtedness (resulting from credit card and consumer loan abuse) among certain sections of the population. The key problem, therefore, appears to be not just *how much* finance is offered to disadvantaged people *but what kind*.

For example, an existing micro-enterprise may want a loan of near the top of the €25,000 limit to develop their business. But unemployed people who want take the first step to earning and independent income often looking for less than *€5,000* according to Micro Finance Institutions (MFI's). The financial needs of people who want to make a transition form the informal economy or from a low paid job to self-employment also tend to require small first steps - as in the case of many women with family responsibilities, migrants, ethnic minorities, people with disabilities and so on. This is particularly the case in the New Member States.

If microfinance is to have a real impact on inclusion and well as sowing the seeds of future competitiveness, then the funding mechanisms must take these social factors into account.

2. THE PROMOTION OF ENTREPRENEURSHIP HIGH ON EU AGENDA

The Spring European Council of 2006 recognises that "fully integrated financial markets and sufficient access to finance are crucial for the growth of small and medium sized enterprises" and in this context EU policy increasingly focuses on identify gaps in the provision of finance where EU action can "add value"[6]. There is general consensus that one of these gaps is in the provision of microfinance. According to the Commission "such loans offer an important means to encourage entrepreneurship through self employment and micro-enterprises and minorities. This instrument favours not only competitiveness and entrepreneurship, but also social inclusion".

In this context, the European Commission relies on two main instruments for promoting micro-credit. Firstly, during the 2007-13 period DG Enterprises' *Competitiveness and Innovation Programme (CIP*) will provide some one billion euros through its financial instruments managed by the European Investment Bank and Fund. Part of this will be devoted to the EIF's Microcredit Guarantee Window which helps reduce the additional risk that financial institutions face when providing micro-credits.

Secondly, there are the various "risk capital" schemes, including micro-credit, financed through the Structural Funds[7]. In this area DG Regio has launched an initiative called the Joint European Resources for Micro to Medium Enterprises (JEREMIE). This allows regions and Member States to use money from the Structural Funds to set up special funds, cofinanced by the EU, to meet the financial gaps faced by their SME's. Once again part, may be devoted to micro-credit and part again may support excluded groups in the labour market.

It is particularly noteworthy that during the 2000-2006 period, the Social Fund also launched a series of loan funds and that in the 2007-2013, microfinance and financial engineering is seen as an eligible action. By its very nature, the Social Fund is closer to the problems faced by people facing disadvantage and discrimination in the labour market, It remains to be seen what role it will play in the future in supporting micro-credit as a tool for both entrepreneurship and fighting social exclusion.

3. TAILORING MICRO-CREDITS TO REAL NEEDS

The individual solutions being tested by EQUAL provide a series of lessons on how to integrate different aspects of micro-finance and to adapt them to the real needs of specific target groups in quite different national and regional contexts.

3.1. RESEARCH INTO NEEDS AND EFFECTIVE OUTREACH FOR SPECIFIC TARGET GROUPS

EQUAL demonstrates how important it is to find out about the real (rather than assumed) financial and business needs of disadvantaged groups. Given the degree of financial and social insecurity some disadvantaged groups face, one needs to guard against taking steps which do not take into account that one or more sources of income (paid work, social security, informal work) could be jeopardised. A shift is required from simply selling a specific financial product to adjusting both products and services (based on solid experience of or research into the target groups) so that they genuinely help to increase income flows and the ability to repay the loan. EQUAL projects like "Supporting Income Generating Activities among Ethnic Groups and Communities" in France[8] have carried out more formal types of research as well as supported efforts by seasoned micro-credit players that branch out and "feel" their way into providing finance for new groups such as ethnic minorities who rely wholly or partly on the informal economy. This demonstrates how effective marketing and outreach is essential to deliver finance to these groups.

3.2. CREATING A SENSITIVELY DESIGNED PACKAGE OF MENTORING AND BUSINESS SUPPORT

EQUAL shows the need within strong welfare states to complement financial products with a sensitively designed package of mentoring and business support to increase investment readiness. One can discern at least two models. Firstly, there are schemes which focus on social support such as the Princes Trust[9]. In some cases, the financial support is totally dwarfed by the "soft" services and is just a small tool of the latter (e.g.

loans of under €500) as in the case of some of the partners of the AWE Equal Project[10] focussing on women in England. Secondly, there are approaches which focus more on innovation within the financial circuit Like San Cosme Innova in Spain[11]. However, both types agree that the services should *never* be used to mask poorly designed financial products.

The content of the business support provided has to be designed to meet the needs of the specific target public and context. This often involves what has been called "financial capacity building" (teaching people how to manage diverse income flows in a way that they can gradually capitalise their activities). However, the initial process of screening and the knowledge that is built up about both the characteristics of the people and the strength of their business plan is also seen as a guarantee against excessive risk.

Mentoring of all kinds is probably the most extensively used form of support. Given the vagueness surrounding this term, EQUAL has worked towards common standards, benchmarks and systems of quality control for mentors. One of the largest mentoring organisations in Europe, the Princes Trust, in the UK has been involved in two EQUAL projects and has developed recognised quality standards for mentors[12].

Another associated support service is the provision of incubators (real or virtual) in order to tackle the absence of consistent support after the business creation and loan provision.

Finally, some projects like Proxy led by ADIE in France[13] have been exploring new services to open up the business opportunities of disadvantaged groups and help them stay in business. These include IT services, legal advice for crisis situations, and recognised training with large employers who can provide markets for micro-enterprises.

3.3. ADAPTING FINANCIAL PRODUCTS AND METHODS TO THE SPECIFIC NEEDS OF CLIENTS

At present, the main focus within EQUAL has been on smaller sized loans and exploring the use of the various techniques for controlling risk (substitutes for collateral). Most[14] are around €5,000 with relatively few schemes with loans of over €15,000.

The need for *collateral* is seen as a major obstacle to credit. In addition to using guarantee schemes such as those of the EIF, EQUAL has demonstrated two ways to deal with this risk. As mentioned above, the first is to substitute a detailed knowledge of the person and the viability of the project with regard to material guarantees, with support services using various methods for simplifying and unifying the documents required for business plans and applications.

The second method is to substitute individual guarantees with group or peer pressure which has been explored by ADIE with migrant women in France[15]. Many of the same schemes also favour "*Step lending*" - starting with relatively small loans, which are renewed progressively after short periods.

There is a growing consensus that *interest rates* are not the most important factor. Many MFI's charge more than market rates in order to increase the sustainability of the funds. Some funds make a fixed service charge in order to avoid religious objections to the payment of interest.

3.4. PARTNERSHIPS TO BRING IN ORGANISATIONS WITH FINANCIAL, BUSINESS AND SOCIAL EXPERTISE

Some EQUAL projects like Garapen[16] in Spain have brought together the public sector, banks, specialist microcredit intermediaries (providing for example a credit board for approval of loans, collateral, supervision of repayments and debt collection) and organisations dedicated to providing the patient business support (in terms of training, coaching, mentoring, monitoring and control) required by hard to reach groups. The non-financial organisations often work as the port of entry to the financial organisation.

3.5. ENGINEERING BOTH ORGANISATIONS AND FUNDING SOURCES TO MAXIMISE SUSTAINABILITY

Although there are exceptions, most of the funds connected with EQUAL aim for operational sustainability. The first strategy is to increase the scope of operations by bringing fragmented microlending initiatives together. For example, in Germany EQUAL has brought together 22 microlending initiatives to form the Deutsches Mikrofinanz Institut[17] and to create a single Federal Fund for Microlending Initiatives backed by EIF guarantees. Local initiatives will tap into this fund by adopting a tripartite common local funding model, thereby, increasing their economies of scale.

A second strategy, followed by many European organisations, is to shift many of the additional costs of dealing with disadvantaged groups onto the support side of the operation. After an initial start-up grant the financial activities themselves are expected to be self-sustaining whereas the necessary business support requires 70-100% public grants.

Another longer term strategy, followed by organisations like ADIE[18] has been to research and campaign for changes in the legislative environment surrounding microcredit and microenterprises. Key issues taken up include:- the ability of non-banks to lend; the abolition of restrictive "usury rates" which cap the level of interest rates that MFI's can charge; improving the legal status of self-employed people; and improving the "welfare bridge" by allowing unemployed to capitalise certain benefits and continue to receive others while they are setting up their business.

Several of the longer standing financial operators within EQUAL are able to provide excellent evidence of the cost-effectiveness of their support[19] (for example one tenth of the annual cost of unemployment in France). Indeed, the average cost of support for microcredit schemes in Europe is reported to be under €5,000 per job created[20]. In purely economic terms this makes intervention worthwhile even if the job created only lasts a year. However, EQUAL support has led to business survival rates of well over 60% after 2 years. In addition, there is the change of mentality, confidence and capacity in people who start to feel that they are serious "clients" of a financial institution rather than the beneficiaries of social support.

Finally, the importance of networking, training and financial capacity building (especially in the use of structural funds and other funding sources) is to be noted. Benchmarking and accreditation services have been developed by organisations like the DMI in order to provide a means to track and guide progress.

4. POLICY RECOMMENDATIONS

The experience of EQUAL can offer the following recommendations that are relevant to the European policy framework.

Financial initiatives to disadvantaged groups would benefit from:

- Solid previous experience of the target group, good outreach and sound research into financial needs ;
- Public support for integrated packages of mentoring and advice in order to build the financial capacities of the disadvantaged and reduce risk for the initiative (not necessarily provided by the same organisation) ;
- Products and methods adapted to the needs of excluded groups and areas, particularly in relation to very small loans, taking account of different methods of guaranteeing/covering risk. Far more experimentation is required particularly in the transition from welfare to entrepreneurship. Possibilities include mutual guarantees, micro guarantees, mezzanine products and insurance products to manage insolvency risk ;

- Reinforcing sector specific national and European networks to increase sustainability and improve both hard and soft skills ;
- Using partnerships with social services and other frontline support workers for bringing financial institutions closer to disadvantaged clients.

Finally, there is a need to document and highlight the changes required in national framework conditions. For this, relevant public sector actors must be involved in the partnerships. These conditions include: progressive tax and social security regimes which facilitate the transition from the informal to the formal economy, the extension and capitalisation of unemployment benefits during the early stages of starting a business, improving the legal status of self employed people, allowing non-banks to lend, easing the "usury" rate and adapting the Basel II agreement to the realities of micro-enterprises.

4.1.1. Notes

[1] etg2-micro-finance_en.cfm

[2] Microcredit for Small Business and Business Creation: Bridging a Market Gap. DG Enterprise. 2003. microcredit_report_en.pdf "Access to finance is harder for SMEs in particular geographical markets, stages of development and industries." Strategic Evaluation of Financial Assistance Schemes to SMEs. Final Report. DG Budget. 2003.

[3] "Regulatory reform (Basel II) will make access to finance harder going forward" so that "the rationale for intervention will be even stronger in the future". Strategic Evaluation of Financial Assistance Schemes to SMEs. Final Report. DG Budget. 2003.

[4] Socially orientated financial networks like FEBEA point to the "general withdrawal of (mainstream) banks from the local economy" and of the "gradual loss the traditional banks of the local and mutual economy (e.g. credit cooperatives) by de-mutualisation, merger or privatisation".

[5] Entrepreneurship and Local Development. OECD 2003 http://www.oecd.org/document/27/0,3343,en_2649_34417_2502299_1_1_1_1,00.html

[6] Implementing the Community Lisbon Programme. Financing SME Growth – Adding European Value. Communication from the Commission COM (2006) 349 Final com2006_0349en01.pdf

[7] Guide to Risk Capital Financing in Regional Policy. Directorate General for Regional Policy 2002. http://ec.europa.eu/regional_policy/sources/docgener/guides/risk/risk_en.pdf DG REGIO provides three reasons for expanding these schemes. Firstly, that "despite many years of providing grant aid from the Structural Funds on a massive scale, regional disparities have not diminished significantly and alternatives therefore have to be considered". Secondly, risk capital financing methods are better suited to the knowledge economy. Finally, "with increasing demands on EU resources arising from the accession of Central and Eastern European countries there is a need to make funds work harder".

[8] etg2-suc-adie.pdf

[9]etg2_doc_prince

[10] entrep-awe_en.cfm

[11] entrep-financial-ladders_en.cfm

[12] cip=UKgb&national=9 and etg2_doc_prince

[13] entrep-07-proxy_en.cfm

[14] See footnotes 7, 8, 9 and 10.

[15] As in footnote 7

[16] entrep-red-accent_en.cfm

[17] entrep-german-microfinance_en.cfm

[18] As in footnote 7

[19] entrep-supporting-income_en.cfm

[20] Estimates of between €1,000 and €8,000 - Financial Instruments of the Social Economy in Europe and their impact on job creation, 1997. Under €5,000 - Finance for Local Development 2002: www.localdeveurope.org